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The Manufacturers Hanover
# Economic Report

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NOVEMBER 1986

## Economic Forecast For 1987

Once again, congratulations are in order. Confounding the pessimists who had written it off as early as two years ago, the current economic expansion has achieved another milestone—its fourth birthday. As a result, the upswing has moved into third place in terms of postwar longevity. And that includes the 106-month expansion which encompassed the Vietnam War; compared with peacetime expansions only, the current upswing is now the second longest and rapidly closing in on the longest, the 58-month expansion which took place in the last half of the 1970s.

It has been a most interesting recovery, to say the least. This is because it is strong in some dimensions and weak in others. Perhaps this "split personality" is what has led some analysts to predict a recession when none has occurred, while others projected a boom with similar disappointing results. For example, looking at the output statistics alone, it would appear that this expansion has been weaker than average. As against a 21 percent gain in the gross national product adjusted for inflation for all recoveries which lasted this long, the current upswing has registered little more than a 16 percent rise in real GNP. However, it is not because of a lack of spending. Real domestic demand has risen by 22.2 percent during the current expansion, compared with 21.9 percent, on average, for the others. The difference stems largely from foreign trade. Real exports have grown only 11 percent in the past four years, less than half the 24.3 percent rise that has taken place in past 48-month upswings. By contrast, real imports have shot up by nearly 66 percent—almost twice the 33.8 percent average rise.

The sluggishness in the output side of the economy has helped drive inflation lower. We have made much more progress in reducing the rate of inflation this time around than we had on average in the past—or, for that matter, in any single postwar expansion. Indeed, the usual case is for the rate of inflation to accelerate when the economy grows. The fact that inflation was reduced at a time when the money supply has grown much faster than it ever has makes this development even more remarkable. Rather than fueling inflation, the surge in money growth appears to have helped push up stock prices. The Dow Jones Industrial Average has jumped by 76½ percent over the past four years—more than three times its average rise and 1½ times greater than the next largest increase which occurred during the 1954-57 expansion.

**Despite Cloudy Crystal Balls ...**

What, then, do all these comparisons mean for the year ahead? Will this expansion live to celebrate its fifth birthday, thus becoming the longest peacetime expansion in the postwar era? The answer, up front, would appear to be in the affirmative—notwithstanding the existence of more than the usual number of uncertainties clouding a forecaster's crystal ball. To begin with, the fact that the ongoing expansion has lasted four years is, just by itself, an uncertainty, since it is already 14 months longer than the average peacetime expansion. While there is no law which limits the life of an expansion, the fact that we have had so many recessions—not just in the postwar era, but stretching back into the early part of the 19th century—would seem to suggest, that sooner or later, this expansion will come to a halt, too.

The trade deficit is another uncertainty. Driving a wedge between consumption and production, the trade deficit may have peaked, but it is unclear how rapidly it will diminish, since the dollar is not as weak as is generally supposed (Economic Report—September 1986). And if the trade deficit remains large and the goods-producing sector stays weak, there may well come a point when this weakness will spill over and begin to affect those sectors that remain strong, notably services, construction and consumer spending.

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Besides these economic uncertainties, there are two political uncertainties which cloud the outlook. The first is tax reform—which represents a major restructuring of the nation's tax system. It has already produced significant cuts in business spending owing to the removal of the investment tax credit and changes in depreciation allowances. It is no doubt affecting consumer spending right now, since sales tax deductions will be eliminated for items purchased after December 31, 1986. And until people are certain as to whether they will come out ahead or behind, they are likely to spend cautiously, producing a further drag on economic activity.

The second political uncertainty is the Gramm-Rudman Deficit Reduction Act. As you know, this mandates a sizable cut in Washington's budget deficit year by year until balance is achieved in 1991. The problem is that the target for fiscal year 1986 which ended September 30 was overshot by a wide margin, as Washington's budget deficit came in at $220 billion. In view of this, it does not seem likely that the target for the current fiscal year, a deficit of $144 billion with a $10 billion leeway, will be met.

The uncertainty deals with just exactly how much the deficit will be brought down and whether or not it will be in line with the expectations of financial market participants. For you see, when this act was passed last year, it helped spark a sizable rally in the financial markets because it appeared at that time that the Government had finally found the key to achieving a balanced budget. However, the decision by the Supreme Court earlier this year which knocked out the automatic spending cut provision, opened the door to 1986's overshoot. If the Administration and Congress cut the deficit too much, it could pull the economy down into a recession. On the other hand, if they don't cut the deficit enough, it could cause a significant backup in interest rates, which would also bode ill for the business outlook.

**... The Absence of Imbalances ...**

Having said all this, our forecast for 1987, as you can see from the table, calls for continued growth with no recession in sight. The year as a whole may log in about the same average growth rate as 1986 and 1985, but the quarterly pattern should be up after softness early in the year. We base this moderately optimistic outlook on the absence of pre-recession signals along with the presence of pro-growth signs.

Developments which have tended to occur immediately prior to a recession are nowhere in sight:

- The economy is *not* overheating. There is enough idle capacity, unemployed workers, and supplies of commodities to keep the economy's temperature, in the form of the rate of inflation, moderate;
- The Federal Reserve is *not* tightening. Interest rates have declined over the past year, with short-term rates well below long-term yields, while the supply of money and credit is growing rapidly. If anything, the Fed may ease another notch before long;
- Fiscal policy is *not* restrictive. Washington's budget deficit, as noted above, continues to grow;
- Consumer demand is *not* contracting. In the first nine months of this year real personal consumption outlays climbed by a healthy 5.6 percent—with a 7.2 percent leap in third-quarter 1986. Continued growth is expected, albeit at a slower pace, since attitudes are positive, buying power is still growing, savings are adequate and use of debt is not as high as it seems;
- The stock market is *not* falling. Equities, as measured by the Dow Jones Industrial Average, have been trading in a relatively narrow range for the past half year, thus keeping both business and consumer confidence at high levels. The record shows that recessions don't usually begin while the market is performing this way;

Besides the absence of negatives, consider the existence of several positive developments:

- *Lower oil prices,* which, although causing severe cutbacks in spending by companies engaged in the business of exploring for, refining and selling of oil, have also boosted the buying power of both business and consumers by lowering many costs;
- *Lower interest rates,* which may have reduced the interest income of those who save, but have also cut costs of those who borrow;
- *The lower dollar,* which, although not down everywhere, has fallen sufficiently against the currencies of enough countries to stop the growth in our trade deficit, thus curbing the drain on output it represents;
- *The jump in employment,* which has produced record numbers of people with jobs, has added to buying power—not to mention bolstered confidence;
- *Higher stock and bond prices,* which have enhanced the purchasing power of those owning these instruments, as well as the attitudes of others.

**November, 1986**
**MHT FORECAST OF GROSS NATIONAL PRODUCT**
**(Seasonally Adjusted Annual Rates)**
**In $ Billions**

| | < Actual | | | Projected > | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1986 | | | | YEAR 1986 | | 1987 | | | | YEAR 1987 | |
| | 1 | 2 | 3 | 4 | LEVEL | % CH | 1 | 2 | 3 | 4 | LEVEL | % CH |
| Gross National Product | 4149.2 | 4175.6 | 4234.3 | 4283.1 | 4210.6 | 5.3 | 4324.6 | 4380.1 | 4451.0 | 4526.0 | 4420.4 | 5.0 |
| GNP: $82 | 3655.9 | 3661.4 | 3683.3 | 3717.5 | 3679.5 | 2.6 | 3731.3 | 3758.1 | 3793.6 | 3830.6 | 3778.4 | 2.7 |
| % Change, Annual Rates | 3.8 | 0.6 | 2.4 | 3.8 | 2.6 | | 1.5 | 2.9 | 3.8 | 4.0 | 2.7 | |
| Consumption | 2697.9 | 2732.0 | 2799.3 | 2806.2 | 2758.9 | 6.1 | 2845.9 | 2885.2 | 2930.9 | 2977.9 | 2910.0 | 5.5 |
| Durables | 360.8 | 373.9 | 410.2 | 389.5 | 383.6 | 6.8 | 392.8 | 397.4 | 404.8 | 411.0 | 401.5 | 4.7 |
| Non-Durables | 929.7 | 928.4 | 935.5 | 944.3 | 934.5 | 3.2 | 956.3 | 967.5 | 979.9 | 993.4 | 974.3 | 4.3 |
| Services | 1407.4 | 1429.8 | 1453.6 | 1472.4 | 1440.8 | 7.8 | 1496.9 | 1520.3 | 1546.2 | 1573.5 | 1534.2 | 6.5 |
| Investment | 708.3 | 687.3 | 674.7 | 698.1 | 692.1 | 4.7 | 694.2 | 698.0 | 712.2 | 720.8 | 706.3 | 2.1 |
| Non-Residential | 459.2 | 457.5 | 461.1 | 466.0 | 460.9 | 0.6 | 451.7 | 458.9 | 461.4 | 475.1 | 461.7 | 0.2 |
| Producers Durable Equipment | 304.6 | 316.0 | 321.5 | 329.0 | 317.8 | 4.7 | 317.6 | 323.6 | 324.4 | 335.4 | 325.3 | 2.3 |
| Structures | 154.6 | 141.5 | 139.6 | 136.9 | 143.1 | -7.5 | 134.0 | 135.3 | 136.9 | 139.7 | 136.5 | -4.7 |
| Residential | 205.3 | 215.3 | 221.1 | 219.8 | 215.4 | 12.3 | 221.6 | 224.0 | 226.8 | 231.0 | 225.9 | 4.9 |
| Inventory Changes | 43.8 | 14.5 | -7.5 | 12.3 | 15.8 | | 20.9 | 15.2 | 24.0 | 14.7 | 18.7 | |
| Net Exports | -93.7 | -104.5 | -110.1 | -108.0 | -104.1 | | -96.6 | -89.4 | -86.2 | -81.8 | -88.5 | |
| Government Purchases | 836.7 | 860.8 | 870.4 | 886.9 | 863.7 | 5.9 | 881.1 | 886.3 | 894.1 | 909.1 | 892.7 | 3.4 |
| Federal Defense | 266.4 | 278.4 | 277.0 | 278.7 | 275.1 | 6.1 | 281.5 | 282.1 | 283.0 | 283.5 | 282.5 | 2.7 |
| Federal Civilian | 89.3 | 89.2 | 88.8 | 104.7 | 93.0 | -1.9 | 94.1 | 92.0 | 91.1 | 98.2 | 93.8 | 0.9 |
| State & Local | 480.9 | 493.3 | 504.7 | 503.5 | 495.6 | 7.4 | 505.5 | 512.3 | 520.1 | 527.3 | 516.3 | 4.2 |
| Final Sales: $82 | 3616.1 | 3646.3 | 3687.8 | 3706.7 | 3664.2 | 2.5 | 3712.3 | 3743.7 | 3771.2 | 3817.0 | 3761.0 | 2.6 |
| % Change, Annual Rates | -1.3 | 3.4 | 4.6 | 2.1 | 2.5 | | 0.6 | 3.4 | 3.0 | 4.9 | 2.6 | |
| Domestic Demand: $82 | 3781.8 | 3815.3 | 3847.9 | 3856.0 | 3825.3 | 3.6 | 3845.9 | 3861.9 | 3889.0 | 3915.1 | 3878.0 | 1.4 |
| % Change, Annual Rates | 3.0 | 3.6 | 3.5 | 0.8 | 3.6 | | -1.0 | 1.7 | 2.8 | 2.7 | 1.4 | |
| Final Domestic Demand: $82 | 3741.9 | 3800.2 | 3852.4 | 3845.2 | 3809.9 | 3.4 | 3827.0 | 3847.5 | 3866.5 | 3901.5 | 3860.6 | 1.3 |
| % Change, Annual Rates | -1.9 | 6.4 | 5.6 | -0.7 | 3.4 | | -1.9 | 2.2 | 2.0 | 3.7 | 1.3 | |
| GNP Price Index (1982 = 100) | 113.5 | 114.0 | 115.0 | 115.2 | 114.4 | 2.6 | 115.9 | 116.6 | 117.3 | 118.2 | 117.0 | 2.2 |
| % Change, Annual Rates | 2.3 | 2.0 | 3.3 | 0.9 | 2.6 | | 2.4 | 2.3 | 2.7 | 2.8 | 2.2 | |
| Consumer Price Index (1967 = 100) | 327.7 | 326.3 | 328.4 | 331.3 | 328.4 | 2.0 | 334.3 | 337.1 | 340.5 | 344.1 | 339.0 | 3.2 |
| % Change, Annual Rates | 1.4 | -1.7 | 2.6 | 3.6 | 2.0 | | 3.7 | 3.3 | 4.1 | 4.4 | 3.2 | |
| Total Personal Income | 3432.6 | 3483.3 | 3501.6 | 3543.3 | 3490.2 | 5.3 | 3582.9 | 3627.8 | 3678.8 | 3742.0 | 3657.9 | 4.8 |
| Disposable Personal Income | 2935.1 | 2978.5 | 2983.0 | 3015.0 | 2977.9 | 5.3 | 3076.2 | 3112.5 | 3153.8 | 3204.4 | 3136.7 | 5.3 |
| Savings Rate | 5.0 | 5.1 | 2.9 | 3.7 | 4.2 | | 4.2 | 4.1 | 3.8 | 3.8 | 4.0 | |
| Unemployment Rate | 7.1 | 7.2 | 6.9 | 6.9 | 7.0 | | 6.9 | 6.8 | 6.8 | 6.7 | 6.8 | |
| Indus. Production (1977 = 100) | 125.0 | 124.4 | 125.1 | 126.3 | 125.2 | 1.1 | 125.3 | 126.6 | 128.6 | 130.2 | 127.7 | 2.0 |
| Housing Starts (000) | 1998.3 | 1908.0 | 1760.0 | 1792.0 | 1864.6 | 7.1 | 1748.7 | 1744.1 | 1757.4 | 1777.5 | 1756.9 | -5.8 |
| Domestic Auto Sales (000) | 7837.0 | 8144.7 | 9699.7 | 7085.9 | 8191.8 | -0.2 | 7284.8 | 7737.4 | 7776.7 | 7970.9 | 7692.4 | -6.1 |
| Corporate Pre-Tax Profits | 224.3 | 231.3 | 243.7 | 265.3 | 241.1 | 8.1 | 261.9 | 273.1 | 293.4 | 301.2 | 282.4 | 17.1 |
| -Taxes | 107.1 | 111.2 | 115.3 | 123.3 | 114.2 | | 123.3 | 129.9 | 139.6 | 143.1 | 134.0 | |
| Net Profits | 117.2 | 120.1 | 128.4 | 142.5 | 127.1 | -3.3 | 139.1 | 143.7 | 154.4 | 158.6 | 148.9 | 17.2 |
| -Dividend Payments | 85.2 | 87.5 | 88.8 | 89.8 | 87.8 | 7.6 | 91.0 | 92.0 | 93.0 | 94.0 | 92.5 | 5.3 |
| Undistributed Profits | 32.0 | 32.6 | 39.6 | 52.7 | 39.2 | -21.2 | 48.1 | 51.7 | 61.3 | 64.5 | 56.4 | 43.8 |
| +Depreciation | 330.9 | 330.2 | 331.8 | 334.8 | 331.9 | | 335.8 | 336.6 | 337.3 | 338.1 | 336.9 | |
| -Inventory Profits | -16.5 | -10.6 | -7.1 | 9.2 | -6.3 | | 8.6 | 9.7 | 14.8 | 15.3 | 12.1 | |
| Net Cash Flow | 379.4 | 373.4 | 378.5 | 378.3 | 377.4 | 0.5 | 375.2 | 378.6 | 383.9 | 387.3 | 381.2 | 1.0 |

Along with continued growth in the economy will come a pickup in the rate of inflation. However, considering the fact that prices at the consumer level declined during the second quarter of this year, while at the producer or wholesale level they remain below year-ago levels, one should not be overly concerned that this represents the first step on the road toward overheating. For whatever increase we do experience in the rate of inflation will have little to do with the pace of expansion, since, as noted above, there is plenty of slack in the economy in the form of idle workers, excess capacity and surplus commodities.

The expected pickup in the rate of inflation can be traced to other developments. For one thing, prices of imported merchandise are rising. This alone, adds to domestic inflation. However, when imported goods' prices rise, they are usually followed by price increases posted by domestic manufacturers who now have more leeway than before, when imports' prices were steady. Another factor that will produce more inflation is oil prices. Admittedly, the price of oil is well below year-ago levels in spot markets. However, it is undeniably higher than earlier this year and if the oil-producing countries can adhere to their production agreement, the price of oil will firm even further. Reduced efficiencies that stem from the combination of high levels of employment and shortages of workers with certain skills and the cutbacks in capital spending, will also add to inflation. Finally, the fact that over half of the consumer price index—the services portion—is already rising at more than a five percent annual rate should be taken into account as well.

**... Assures Continued Expansion**

In conclusion, the best bet is that the economic expansion will continue and that a year from now the birthday cake will have one more candle on it. The current and projected state of the economy may not seem to be ideal for many—but it is far from negative for most. Maybe this is why the expansion will live on.

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# Economic Report

January 1987

Commentary on Pertinent Economic Issues

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## Restructurings, Takeovers and Debt

Streamline. Restructure. Become lean and mean. Reorganize. Spin off. Buy back. Merge or acquire. These and other words are being used to describe what amounts to the greatest overhauling of corporate America in the postwar era. Many of today's top companies look very different than they did just a few short years ago. Some corporations have gotten bigger by buying others, while other companies have become smaller by selling some of their divisions. By some estimates, nearly a fifth of the current market value of all traded stocks has changed hands in the past four years alone.

Wall Street has apparently voted in favor of this corporate reshuffle. In the first nine trading days of this month alone, stock prices surged by more than seven percent, sending the averages into record territory. Of course, there are others, especially those who have had to restructure their companies because of takeover threats, who decry these developments. Their words have not fallen on deaf ears in Washington, since a number of congressmen have begun to talk about the need for legislation to suppress, or, at the very least, regulate such activity.

Neither side has a clear-cut case. Like so many other things that happen in our economy, these changes are either good or bad depending upon one's perspective. What follows below is an attempt to lay out both sides of the arguments that have been made on the subject of restructurings, takeovers and debt.

### PRO

**The separation of ownership and control in most publically-held companies has resulted in managements pursuing size for its own sake to justify higher pay, more perquisites and greater social status for themselves. Those who have sought to take over companies, whether successful or not, have forced management to think more like owners and to boost shareholders' values.**

**Big business may be characterized as bloated, risk-averse, inefficient and unimaginative with excessive layers of staff between managers and markets that has been dubbed "corpocracy". Large corporate size is believed to correlate more with high executive pay than with high profits or stock prices.**

### CON

*In many instances this has resulted in companies taking a short-run view at the expense of the longer term. Assets have been reshuffled; companies have gone private, then public; owners have changed frequently without any basic change in operations. In any event, many companies have already been forced to become leaner by competition both here and abroad.*

*Large size by itself should not be condemned since it has many redeeming qualities including stability and predictability, not to mention economies of scale. At any rate, companies of all sizes would do better if U.S. economic policies were more appropriate. Washington's record budget deficits adversely affected companies both large and small by pushing interest rates to record levels several years ago, thereby making the dollar so strong as to destroy our competitiveness both here and abroad. Tax reform will only worsen matters by depriving many businesses of the incentive to invest, thus keeping them from becoming more efficient.*

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| PRO | CON |
| --- | --- |
| If raiders are opportunists, poor management has given them the opportunity. These raiders must see value in what they are buying; they obviously believe they can do better than current managements, otherwise they would not offer a premium over listed market prices. In some respects they are buying up companies at wholesale prices and selling off parts at retail prices. At any rate, leaner, more efficient companies are resulting, not only from actual takeovers, but from fears of them as well. | *Defenses that companies are erecting to maintain their independence wind up costing jobs as divisions are spun off and staffs whittled down. Funds that would otherwise be invested in research and development are instead paid out to shareholders, sacrificing long-run growth potential, productivity and competitiveness. Naturally, this hurts the economy. Insofar as raiders doing better than management is concerned, we don't know, since few have actually wound up owning the companies they threatened to take over. What is more, if the stock market did not undervalue Corporate America, these raiders would not be able to buy at wholesale and sell off parts at retail. Managers are so busy worrying about takeovers that they have difficulty concentrating on competitiveness.* |
| Let's follow up on the undervaluation of Corporate America by the stock market. It has been calculated that the Q ratio, or the market value of corporate assets as a proportion of their replacement costs, although up in line with the jump in stock prices, is still below one. Therefore, it pays to buy stocks in order to obtain corporate assets rather than to build new assets directly. Correcting for inflation, the popular market averages remain anywhere from 25 to 45 percent below the peaks they reached in the 1960s, while real nonfinancial corporate assets have more than doubled in value over this time. | *Reorganization doesn't always create value. The company must be able to increase its sales volume or selling prices or become more efficient in order to justify higher share prices. Otherwise, this is a zero-sum game: Someone gains because someone else loses.* |
| The stock market likes these restructurings, since it places greater value on companies engaged in this pursuit on the notion that restructurings will produce more efficiency and more profits. | *The stock market may overestimate a company's breakup value. It may also overlook debt taken on which will not be used to finance the purchase of plant and equipment or for research and development, thus enabling the company to grow and better service this debt. Besides, the rating agencies have lowered their opinions of companies taking on these large debts, while recent studies have suggested that merger and acquisition situations eventually result in lower stock prices for the company or companies involved, rather than higher.* |

| PRO | CON |
|---|---|
| Let's talk about debt. More leverage enhances shareholders' returns. The tax law—even under tax reform—still makes debt less expensive than equity, since interest costs are deductible while dividends are not. What's more, high debt levels put managers under pressure, thereby encouraging them to improve their performance. | *High interest costs associated with greater debt levels will hurt when the next recession comes around and corporate profitability, thus cash flow, is diminished. Interest paid as a percentage of pretax profits, although down from its 1982 peak, is still around 50 percent, compared with less than 25 percent in the 1970s, and around 10 percent in the 1950s and 1960s. Higher debt levels means funds must be diverted from such other uses as research and development, job creation and capital spending to pay interest. In any event, managers should not have to operate at gunpoint; worthwhile corporate goals can be achieved through economic growth and technological change.* |
| Debt levels aside, if you make managers into owners, they will do a better job. Managers should have more than a nominal amount of equity in the companies for which they work. At the very least—they should think more like owners. | *It may be true that managers should never lose sight of the fact that they are managing their companies on behalf of the owners. However, it is also true that owners nowadays tend to be big institutions themselves, such as pension funds, life insurance companies, bank trust departments, etc., whose holdings are diverse and whose attachment to the companies whose stocks they own lasts only as long as quarterly earnings are strong. In addition, most firms have to cope with a broad range of special interest groups besides those of their owners. Businessmen must deal with governments at various levels, unions, local community groups, and the press. Because of these diverse audiences, it is not practical for managers to run their companies with the immediacy demanded by the raiders.* |
| The purpose of business is to make money for its owners—which many of today's managers seem to overlook except when they are pushed. | *What about the responsibility that a company has to its employees, to the community in which it is domiciled, and to society at large? These obligations can only be measured by taking a longer-term view.* |
| Focused firms do better. | *Diversification is an anticyclical measure. When one industry is down another might be up. This helps to keep the company strong and its jobs secure.* |
| Actually, some corporations make life insecure by going into areas that they don't know, many times with negative results. These corporate errors tend to be tolerated, but raiders cannot afford such mistakes. | *No company deliberately goes into an area that it doesn't know. Companies diversify in order to smooth out the impact of the business cycle as well as to grow. Flexibility is important.* |

(Continued)

As you can see, there are good arguments on both sides of the restructuring phenomenon that has stuck Corporate America these past few years. No doubt some of these overhauls have been necessary. There may be some truth to the argument that when ownership is separated from control, managers tend to act in their own self interest, rather than those of the shareholders. However, some of the tactics that have been employed to rid Corporate America of these alleged excesses and inefficiencies are questionable at the very least.

In particular, there is the development that has come to be known as "greenmail". This is the ransoming by a company of its stock from the clutches of a raider who has bought some shares and has threatened to buy enough to take it over. This practice should be eliminated by making it illegal for a company to buy out one shareholder at a price not offered to all the others. This would also help to curb another abuse: The threat of a takeover without binding finances which stampedes stock into the hands of arbitrageurs and speculators by putting a company into "play". Many corporate managers believe that raiders don't really want to run companies—they just want to make a quick profit. If greenmail were eliminated, the raiders would have to make good on their threat to take over the firm.

It is too soon to say with certainty what the impact of these restructurings has been on the economy, since the process has not played itself out. So far, there have been winners and losers. The winners, of course, are those who have invested in the stock market, where prices have risen reflecting in part, the reduced supply of equities in the public arena and the realization that stock prices have undervalued the assets of Corporate America.

Among the losers are holders of corporate debt instruments when restructuring produces additional issuance of debt, as well as employees who have lost their jobs through corporate downsizing. While these restructurings are supposed to improve efficiency, growth in output per hour worked in the private business sector has been much slower in this expansion than it has in the past; productivity actually flattened during most of 1986.

Finally, the ability of Corporate America to handle higher and more expensive debt loads will not be fully tested until the next recession rolls around. Given the shape of their balance sheets, many corporate managers are not looking forward to taking this particular test. ■

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MANUFACTURERS HANOVER

# Economic Report

March 1987

Commentary on Pertinent Economic Issues

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Manufacturers Hanover Economics Department 17/270

## Deficits And The Dollar

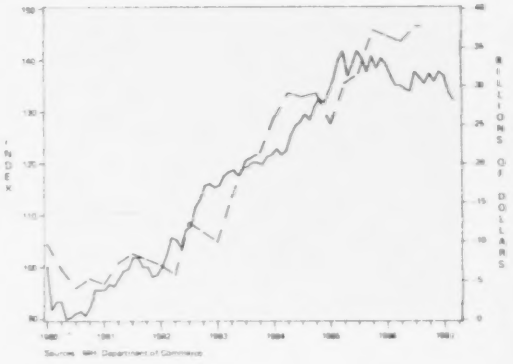
Over two years have passed since the U.S. dollar began to decline in the foreign exchange markets, and yet our trade deficit has continued to grow. Not surprising, the passage of legislation to close this gap has emerged as the number one item on Washington's agenda. Elected officials are feeling intense pressures from their constituents, and it's not hard to see why. For the last three years, the widening trade gap prevented reasonably good growth in domestic spending from being translated into similar strength in output, as people purchased more and more foreign-made goods. The gross national product adjusted for inflation last year grew one percentage point less than it would have if the trade gap had merely stabilized. Both business failures and the jobless rate remained high.

It will be very tempting for the politicians to take a heavy-handed approach to trade, for they are seeking quick results. They want to slow imports while boosting exports, and they are prepared to use tariffs, quotas or surcharges to achieve these objectives. In addition, you may expect to hear more about fair trade and reciprocity, as Washington seeks to prod others either to stop subsidizing their exporters, and/or to open their markets to more of our exports. However, correcting our trade imbalances by legislation is fraught with risks. For one thing, while no one would maintain that we have free trade today, any omnibus trade bill would invite retaliation by others, leaving all of us worse off. For another, any generalized legislation would overlook the many reasons why our trade deficit remains large.

### The Strength Of The Dollar . . .

In my opinion, the number one culprit is the continued strength of the dollar. The Manufacturers Hanover trade-weighted dollar, which is adjusted for inflation, has declined by less than ten percent over the last two years (Chart I). By contrast, the Federal Reserve's measure is off by more than 35 percent. One of the reasons our index shows such relative dollar strength is that it contains more currencies than the Fed's—and the dollar hasn't declined as much against these other currencies as it has against the major units. But even where the dollar *has* fallen a lot, exporters from these countries are not raising their selling prices by as much as their currencies have gone up.

CHART I
REAL MH TRADE-WEIGHTED DOLLAR <JAN. 1980=100> (LINE)
VS. MERCHANDISE TRADE DEFICIT BOP BASIS (DASH)




Perceived differences in product quality also play an important role in the deficit issue. Right or wrong, many people think that certain foreign-made goods are better than ours and they're willing to pay more to get them. Besides this, in a number of instances, there is virtually no comparable domestic product. Videocassette recorders are a good example: They are for the most part made in Japan and other East Asian countries. In other cases, such as oil, we don't make or produce enough to satisfy our domestic demand.

### . . . Along With Other Factors . . .

Reacting to the initial rise in the value of the dollar—not to mention a more favorable labor climate—many U.S. companies have moved their operations offshore. To the extent they export, we've lost them, and when these goods are brought back here, they are recorded as increased imports. Additionally, the march of technology, by simplifying the production and assembly of a growing number of items, has enabled countries with the lowest labor costs to capture these markets. These tend to be the developing countries from the Pacific Basin and from Latin America with whom our

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bilateral trade deficits continue to grow. On another front, the Commerce Department alleges that many U.S. companies don't have much of an interest in exporting. They don't want to take the time and trouble to learn the customs, laws and languages of other countries—as evidenced by the protracted decline in exports' share of GNP.

Let's not forget the reaction of the developing countries to their debt burdens. In an effort to convert their own trade deficits to enough of a surplus for them to service their debts, most such nations have slashed imports and pushed exports—especially of farm products and raw materials. Unfortunately, such actions, albeit necessary, have adverse as well as favorable results. For example, our trade surplus of $7 billion with Latin America in 1981 turned into a deficit of about $12 billion last year, while our farmers are suffering from the worst combination of falling prices and depressed land values since the 1930s.

### . . . Calls For A Variety Of Strategies . . .

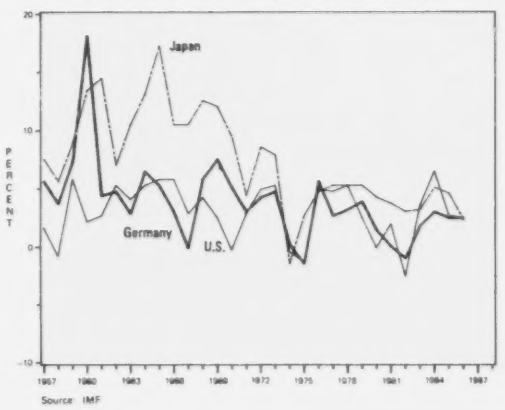
These varied factors call for not one approach—but several different strategies to shrink our trade deficit. To be sure, Washington should not abandon its theme of reciprocity. Free trade means fair trade: others should not give their domestic producers an unfair advantage by subsidizing their exports or restricting imports unless they are prepared to face the same thing here.

Then there is the value of the dollar. It would appear that the buck will have to fall further against some of the currencies where it has already declined substantially in order to force exporters from these countries to raise their selling prices enough to dampen U.S. demand. The dollar will also have to fall against the currencies where it has declined very little—or even risen.

This contrasts with the view taken by the finance ministers of the major industrial countries at their recent meeting in Paris. Their communique said in part that the dollar was appropriately valued, and that it should remain close to present levels. While not specifying exact targets—or even acknowledging that they had specific ranges in mind—they agreed that the dollar had fallen enough. They did not say they would intervene—but they did not say that they wouldn't. What is more, they promised to try to coordinate their economic policies. This is because they want the fundamentals which determine currency rates in the long run—inflation, growth, current account balances and real interest rates—to converge, thus supporting their efforts to stabilize the major currencies.

In my opinion, this is easier said than done. As you can see from Chart II, annual rates of growth of the economies of the United States, Germany and Japan have varied all over the lot in the past 20 years. Convergence was rare—and accidental, at that. It is hard to imagine that the major countries are ready to coordinate their economic policies now, since the U.S. and Canada, to name two, cannot even agree on how to enter into a free trade zone. Indeed, history teaches us that nationalistic considerations almost always override broad international objectives. Only when one nation is strong enough to impose a solution on the rest do major international problems get solved. While the U.S. was able to do this right after World War II, it is evidently unable to do so today.

CHART II
GROWTH IN REAL GNP OF SELECTED INDUSTRIAL COUNTRIES



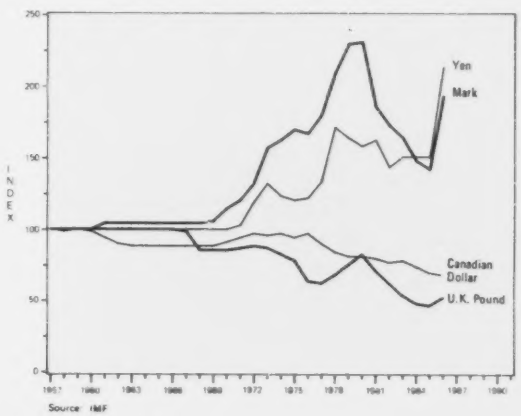
Source: IMF

In addition, free markets will always have the potential for volatility. This applies whether the markets consist of foreign currencies, commodities, stocks or interest rates. And, since currencies began floating in 1973, there is no longer any way that any one central bank—or even a group of them—can impose stability, since the markets are now many times larger. Chart III shows how volatile the major currencies have been since the Bretton Woods fixed-exchange rate system ended in 1971.

Furthermore, our calculations suggest that the U.S. dollar remains overvalued. Therefore, stabilizing it at current levels will not do much to reduce our trade deficit. We base this belief on the theory of Purchasing Power Parity. This compares items that can be bought for a dollar in the United States with their cost overseas in local currencies. Right now, for instance, it would appear that the U.S. dollar has fallen so swiftly compared with the West German mark that it is now undervalued against this key currency. This can be seen from the fact that it takes about two D-marks to buy in Germany what one dollar buys in the United States, although the exchange rate at mid-month was about 1.85 marks to the dollar.

But Germany is only our fourth largest trading partner. Against the currency of Japan, our second largest trading partner, the dollar remains overvalued—notwithstanding what seems to be a decline nearly equal to that registered against the mark. This is because all it takes is 150 yen to buy in Tokyo what one dollar buys in the United States, while the exchange rate at mid-month was nearly 153 yen to the dollar. The U.S. dollar is even more overvalued against the currency of Canada—our largest trading partner. It costs only about 1.15 Canadian dollars to buy the same goods in Canada that one dollar buys here, while one must give up 1.33 Canadian dollars to obtain a U.S. dollar in the foreign exchange markets. The dollar is also overvalued against the currencies of several Pacific Basin countries. All in all, we estimate that the U.S. dollar at mid-month was still at least 15 percent too strong, when measured against the currencies of our major trading partners.

CHART III
VALUE OF SELECTED CURRENCIES IN U.S. DOLLARS
<JANUARY 1957=100>




Getting back to the other approaches the U.S. might employ to shrink its trade deficit, improving the quality of the goods we produce won't be easy. It will require a commitment on the part of labor and management that is now seen in only a few industries. We must also encourage investments from abroad. This way, we'll be able to overcome the fact that we don't produce certain items, or that some of our companies have set up shop elsewhere. Obviously, we should reduce our reliance on imported oil. A tax would seem to be the answer, and it would have the additional benefit of helping our domestic oil industry get back on its feet. We can't do anything about technological change, but we can concentrate on producing what we're good at, using our natural advantages. This means greater emphasis on those products requiring advanced technology, substantial capital investments, and highly skilled labor.

### . . . To Shrink Our Trade Deficit

Washington needs to help industry restore its international competitiveness. Besides education and training, elected officials should consider changing the tax code so that savings and investment are encouraged—not discouraged as they are now. Other countries need to grow faster, otherwise they won't be able to import more from us, no matter what our exporters do. This is true also for the developing countries, whose debt burdens must be lightened enough to allow them to increase their imports from the U.S.

Let's not forget our other deficit—the red ink in Washington's budget. It was responsible for pushing the dollar skyward by forcing interest rates up, thereby attracting foreign money here. If we do manage to reduce our trade deficit without cutting our budget deficit by at least as much, we'll wind up with more problems than we solve, because a lower trade deficit will shrink the amount of funds foreigners have to put into our financial markets. In turn, this would mean higher interest rates if the Federal Reserve doesn't become more accommodative, or more inflation, if it does. ■

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MANUFACTURERS HANOVER

# Economic Report

May 1987

Commentary on Pertinent Economic Issues

## The Disappearing Invisible Hand

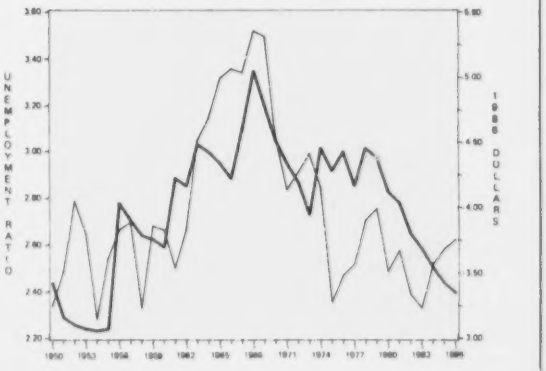
**Irwin L. Kellner**
**Chief Economist**

Americans seem to be increasingly dissatisfied with the workings of the marketplace. A spate of articles has recently appeared questioning the benefits of deregulation in a number of industries. In some cases, such as the nation's telephone system, deregulation has brought forth higher prices for many users, as well as a good deal of confusion when it comes to determining responsibility for repairs. In other cases, such as the airlines, prices have fallen–but so has service. And when it comes to dealing with such issues as the environment, the public, according to recent surveys, wants more–not less–government involvement.

This attitude has not gone unnoticed in Washington. For while the government has been deregulating with one hand, it has been interfering with the workings of the marketplace with the other. Remember the "voluntary" restraints on imports of Japanese cars? These came about early in the Reagan Administration as did similar efforts to slow down imports of steel from Brazil and textiles from the Far East. Not too long ago, the Administration got into a flap with our neighbor to the north which led to the President imposing tariffs on Canadian lumber. Washington has also threatened to impose tariffs on imports of food from the Common Market, and just recently, did levy a 100 percent tariff on certain microchips produced in Japan. The domestic front has not been left untouched, either, since Congressional Democrats have just proposed an increase in the minimum wage.

Before this goes any further, it might be helpful if readers remember what happens when markets are not allowed to clear. That is–what the consequences are of the government passing laws or taking such other actions as imposing import restraints that interfere with the normal process of supply and demand by sending out incorrect signals to the markets. Surpluses or shortages will arise, depending upon the relation of the price that the government seeks to establish compared with the price that would otherwise be set in the marketplace. And there will certainly be an effect on prices if the government acts to alter supply or demand.

CHART I
RATIO OF TEENAGE UNEMPLOYMENT RATE
TO TOTAL UNEMPLOYMENT RATE (THIN)
VS. REAL MINIMUM WAGE (THICK)




### Price Floors . . .

Let's take the minimum wage, for starters. Chart I shows the marketplace in action. Washington may mandate increases in the minimum wage from time to time, but it cannot force employers to hire the people most likely to be affected by this–teenagers. The heavy line depicts the minimum wage adjusted for inflation. As you can see, it peaked in the late 1960s. It has fallen sharply since 1981 because the minimum wage has been unchanged over that time while consumer prices have advanced by more than 26 percent. This may seem inequitable until one examines the relative ability of teenagers to find jobs.

It was toughest for youngsters to find work in the late 1960s–just when the real minimum wage was at its highest. It is relatively easier today, as you can see from the decline in the thin line which compares the teenage unemployment rate with the total unemployment rate. One should compare the *ratio* of teenage unemployment with total unemployment, rather than looking at teenage unemployment in the absolute. This way, it is possible to transcend the business cycle. In other words–in 1968 the teenage unemployment rate was about 3½ times the total unemployment rate whereas today it is a little more than 2½ times. This appears to be largely because the minimum wage today is

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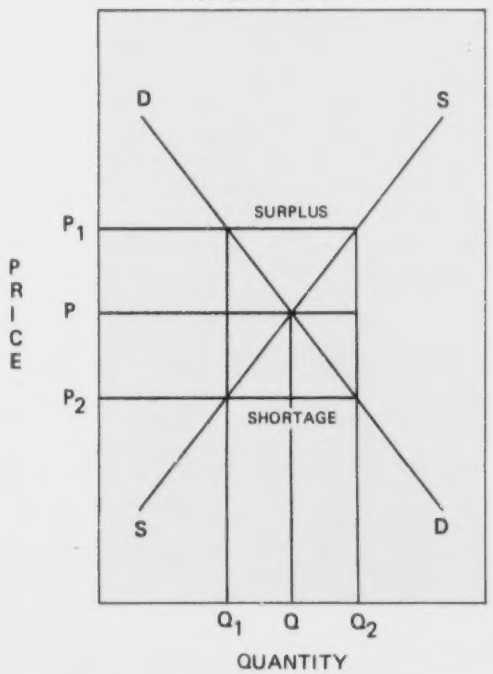
more palatable to employers relative to other costs of doing business than it was in the 1970s or in the 1960s.

Another way to look at this is through Chart II. Students of economics will recognize this as a traditional supply and demand chart with price on the vertical axis and quantity depicted horizontally. For a normal commodity, as prices go down more will be demanded, hence the downward sloping line of the demand curve from left to right, but less will be offered. As prices go up, less will be demanded and more will be offered, witness the upward slope of the supply curve from left to right. At price levels P and quantity levels Q the amount offered is equal to the amount demanded and the markets are said to clear.

CHART II
SUPPLY AND DEMAND:
PRICE FLOORS AND CEILINGS




If, however, the price were to rise to $P_1$ [an increase in the minimum wage], the number of job openings [$Q_1$] would fall short of the number of applicants [$Q_2$] and a surplus [a higher than average jobless rate] would result. This is because the minimum wage, most times, appears to have been higher than the wage employers would offer to entry-level people in the free market.

Those who advocate an increase in the minimum wage no doubt have the best of intentions. They seek to increase the income of those who are either paid the minimum wage or very close to it. However, and notwithstanding the fact that higher wage costs will lead employers to raise selling prices thereby producing more inflation, the initial effect of a rise in the minimum wage appears to be the creation of additional unemployment–especially among teenagers and other entry-level workers. It would be interesting to know how many of these people would prefer to be employed at $3.35 an hour rather than unemployed at the proposed minimum of $4.65 an hour.

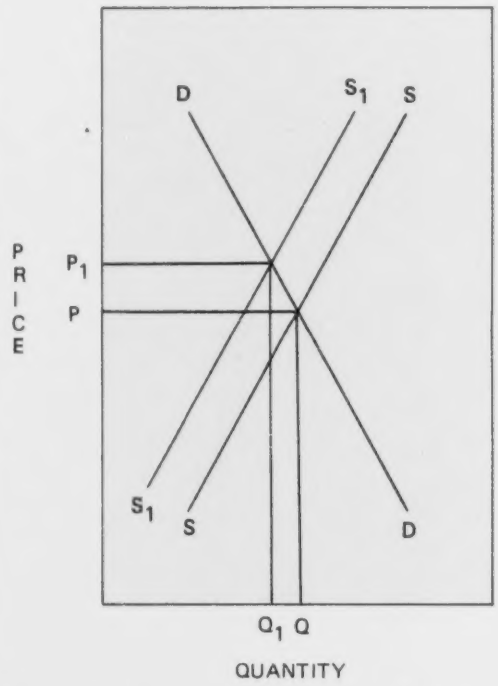
By the way, the same analysis holds true for the nation's farm problem. We have surpluses of farm commodities stacked up in storage bins because the government for years has been supporting prices above their market levels.

**. . . And Price Ceilings . . .**

Chart II also shows what can happen when the government interferes with the price mechanism in an effort to keep the price *below* the market price [represented by $P_2$]. In this instance, the quantity supplied shrinks from Q to $Q_1$ since it is less profitable to offer the item in question. On the other hand, the quantity demanded expands from Q to $Q_2$ as buyers perceive a bargain. In this case, the difference between the quantity supplied and the quantity demanded is a shortage. And lest you think this is only a classroom example with no application to the real world, I would remind you that the United States has experienced shortages many times in the past, most recently when the government levied controls on prices of petroleum products. Lines formed at gasoline stations in many parts of the country reflecting the inability of the markets to clear.

Have we learned from this experience? I am not sure. Interior Secretary Donald P. Hodel recently predicted that "people would be sitting in gas lines any time within the next two to five years". He must be planning to control oil prices, because that's the only way that this is going to happen. As long as the price mechanism is allowed to apportion supply and demand, there will be plenty of oil available at affordable prices. For if prices do rise, they will bring forth additional quantities of oil while at the same

CHART III
SUPPLY AND DEMAND:
QUOTAS




time cutting back demand in the form of conservation. If this sounds familiar, it is because this is exactly what has been happening since the first round of oil price increases nearly 14 years ago.

**. . . Create Surpluses And Shortages . . .**

Americans have already become more efficient users of oil. Automobiles are a good example. Fourteen years ago, the nation's automobile fleet averaged 13 miles per gallon; last year's fuel efficiency was 18.3 mpg. And since today's new cars average 42 percent better mileage than even this figure, you can be assured that motorists will be using even less gasoline over the coming years. For the economy as a whole, thanks to better home insulation and substantial capital investment by businesses in energy-saving structures and equipment, the relationship between energy use and economic growth has changed significantly over the past dozen years. During the half-century prior to the mid-1970s, each one percent rise in GNP output required a one percent increase in energy input. Since then that ratio has changed drastically: Each one percent rise in energy use now supports an eight percent rise in the real GNP!

**. . . While Quotas Add To Inflation**

Turning back to the international scene, Chart III shows the effects of one form of restraint of trade: Quotas. The chart is laid out the same way as Chart II. The main difference here is that, instead of acting on the price level, the government acts on the quantity available. The quantity supplied and demanded at market price P is Q. However, when the government limits the quantity of, for example, imported autos from Japan, it shows up as a change from Q to $Q_1$ on the horizontal scale and a shift in the corresponding supply curve from S to $S_1$. Assuming the same demand, you can see that the new supply curve intersects with demand at a higher price, $P_1$.

In other words—by restricting the supply of Japanese-made automobiles, the government has caused their price to go up. This is supported by a Brookings Institution study, which concluded that the "voluntary" quotas on Japanese cars caused their prices to go up by an average of $2,500. The Brookings study also said that, because of the umbrella provided by higher-priced Japanese imports, the price of an average American car went up by about $1,000 at the same time. Thus Americans are estimated to have paid an extra $26.6 billion in 1984 and 1985 as a result of these restraints. Furthermore, a study produced at Georgetown University concludes that protection from imports of all kinds cost U.S. consumers $65 billion in 1986!

With the dollar down substantially against such major currencies as the Japanese yen and German mark, you can see why inflation fears are once again permeating the financial markets. A lower dollar means higher prices for imported goods, which, in the past, has usually been followed by similar price increases posted by domestic manufacturers. The threat of more inflation has caused interest rates to rise and the stock market to fall. If these trends continue, our 4½-year economic expansion will be in jeopardy.

It is ironic, therefore, that an Administration which came in determined to lick inflation and revitalize the economy may well leave office doing just the opposite if it continues to interfere with the workings of the Invisible Hand. ■

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MANUFACTURERS HANOVER

# Economic Report

July 1987

Commentary on Pertinent Economic Issues

**Irwin L. Kellner**
**Chief Economist**

Manufacturers Hanover Economics Department 17/270

## Business Conditions Update

Summer 1987 finds the U.S. economy approaching another milestone. July marks the 56th month that the economy as a whole has been expanding. This is only two months shy of the all-time record for a peacetime upswing, which was set in the late 1970s. There is little doubt that this record will fall come October, since virtually all economists expect business to continue growing for the rest of this year.

### Despite Numerous Negatives . . .

The reader should be aware that these forecasts of continued economic growth are being made in the face of a number of uncertainties. The first is the age of the expansion itself. Trees don't grow to the sky, and people don't live forever. Since records were first kept in the mid-1800s, the U.S. has experienced 30 recessions, averaging 18 months in duration (eleven months since the end of the Second World War). Because the current upswing is now two-thirds longer than the average postwar peacetime expansion, one has to keep in mind that the probabilities of the expansion coming to a halt are clearly greater today than they were a year ago–not to mention in 1985.

Then there is the trade deficit. True, it has receded from its high point reached in the third quarter of 1986: According to the government's preliminary estimates of the second-quarter gross national product, our foreign trade deficit, adjusted for inflation, is now $34 billion, or 21 percent, lower than it was at its peak in the third quarter of 1986. However, this brings the trade deficit only back to where it was in the first quarter of 1986 – and that still represents a substantial drain from the goods-producing sector of the economy. It also represents another addition to our foreign debt–which at the end of last year amounted to $264 billion, 2½ times the debt burden of Brazil, the world's second-largest debtor.

Tax reform is another question mark. The new tax law has had several effects on the economy. First, it distorted the economic statistics by encouraging consumers to shift forward their planned expenditures on big-ticket items from 1987 to yearend 1986 in order to capture the sales tax deduction that was eliminated on January 1 of this year. This rush of spending late last year caused business inventories to drop by the largest amount since the end of the last recession. As a result, the gross national product in 1986's fourth quarter grew only one third as fast as it would have, had inventories held steady.

This surge in demand led some economists and businessmen to conclude that the economy was speeding up. Not surprisingly, production schedules were maintained or even increased early this year and inventories were rebuilt. However, and also not surprisingly, demand subsequently diminished and, as a result, all of the growth that took place in this year's first quarter, and then some, traced to inventory accumulation. This decline in sales caused other economists to think that the economy was slowing down–if not going into reverse. The second quarter's figures, showing somewhat less inventory accumulation but a resumption of growth in demand, were probably more indicative of the underlying trends during the previous six months. Tax reform also managed to cut into business spending, especially for structures. Outlays in the second quarter were 18 percent below the levels reached in the fourth quarter of 1985, after adjusting for higher prices.

Another uncertainty is the status of Washington's budget deficit. To be sure, it looks very good for the current fiscal year. Three-fourths of the way through fiscal year 1987, Washington's budget deficit appears to have shrunk considerably from last year's record. To the extent that spending and revenue trends for nine months can be extrapolated to a full year, the deficit is running at an annual rate of $158 billion in FY 1987, $63 billion, or nearly 30 percent, below last year's $221 billion. However, this is not as good as it seems. For one thing, it is still far above the Gramm-Rudman target for the current fiscal year of $144 billion. For another, most of the decline is believed to be a one-time result of the enactment of the tax reform law. Other than people in the Administration, virtually no one is expecting the deficit in FY 1988 to decline from current

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levels. And while a deficit in Washington's budget does impart stimulus to the economy, it also puts pressures on the financial markets by increasing Washington's demands for funds, thereby keeping interest rates higher than they otherwise would be.

If these developments were not enough, there have recently appeared a number of signs that in the past have signaled the onset of recession:

- *An acceleration of inflation.* After falling at a 1½ percent annual rate in 1986's second quarter, prices at the consumer level shot up at a 5½ percent clip in the first six months of this year. That's the fastest six-month rate of rise in almost five years. What is more, producer prices of intermediate materials excluding food and energy have been accelerating. From a decline of 1½ percent at an annual rate a year ago, these goods rose at a 0.8 percent clip in last year's third quarter, 1.5 percent in the fourth, 2.7 percent in 1987's first quarter, and 3.5 percent in the second. And at the earliest stage of production, prices of industrial raw materials have shot up by nearly 25 percent over the past year. Needless to say, prices of imported goods are up sharply, reflecting the decline in the dollar, while the price of oil in spot markets is more than double its low point of April 1986.

- *Rising interest rates.* Since touching bottom in autumn 1986, money-market interest rates have risen by about one percentage point, prompting the nation's commercial banks to increase their prime lending rates by ¾ of one percentage point. Long-term yields have advanced even more–and in a shorter period of time. A tightening of monetary policy by the Federal Reserve, along with increased concerns in the markets about inflation, appears to be responsible.

- *A jittery stock market.* Its rapid runup so far this year, combined with the increase in interest rates and the drop in the dollar, has made many investors leery of further commitments to equities.

- *Fewer domestic car sales.* New auto purchases so far this year have declined considerably. After running at a tax reform-induced rate of 9.7 million units in 1986's third quarter, the pace of new domestic auto sales slumped to seven million in this year's second quarter. For the first six months of this year, they are down ten percent from 1986's comparable period–and are 15 percent lower than they were during the same time in 1985. June's sales were the lowest for the month in five years.

- *Less residential construction.* In the wake of sharply higher mortgage interest rates and higher prices, housing starts have fallen for four months in a row, a development that last occurred prior to the 1981-82 recession. So far this year, the rate of new-home construction is 11 percent below the same period of 1986. June's new-home starts were the lowest for any month in three years.

### . . . We Should Avoid A 1987 Recession . . .

In the past, when autos and housing were falling, the U.S. economy soon lapsed into recession. This is because these two industries directly and indirectly account for a big chunk of the gross national product and a substantial number of jobs. However, this time around the U.S. should be able to avoid a recession–at least in 1987. The key to this cautious optimism lies in what has already taken place in the foreign exchange markets and its impact on our trade deficit.

**July, 1987**
**MHT FORECAST OF GROSS NATIONAL PRODUCT**
**(Seasonally Adjusted Annual Rates)**
**In $ Billions**

| | < Actual Projected > | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1986 | | | | YEAR 1986 | | 1987 | | | | YEAR 1987 | |
| | 1 | 2 | 3 | 4 | LEVEL | % CH | 1 | 2 | 3 | 4 | LEVEL | % CH |
| Gross National Product | 4174.4 | 4211.6 | 4265.9 | 4288.1 | 4235.0 | 5.6 | 4377.7 | 4448.8 | 4541.7 | 4639.8 | 4502.0 | 6.3 |
| GNP: $82 | 3698.8 | 3704.7 | 3718.0 | 3731.5 | 3713.3 | 2.9 | 3772.2 | 3796.4 | 3823.3 | 3849.9 | 3810.5 | 2.6 |
| % Change, Annual Rates | 5.4 | 0.6 | 1.4 | 1.5 | 2.9 | | 4.4 | 2.6 | 2.9 | 2.8 | 2.6 | |
| Consumption $82 | 2409.8 | 2434.3 | 2477.5 | 2480.4 | 2450.5 | 4.2 | 2476.0 | 2488.7 | 2508.6 | 2525.3 | 2499.7 | 2.0 |
| Durables $82 | 359.8 | 369.6 | 405.5 | 399.0 | 383.5 | 8.7 | 375.9 | 386.2 | 385.4 | 386.3 | 383.5 | 0.0 |
| Non-Durables $82 | 868.8 | 880.0 | 879.8 | 880.3 | 877.2 | 3.3 | 883.2 | 873.6 | 885.5 | 892.8 | 883.8 | 0.7 |
| Services $82 | 1181.2 | 1184.7 | 1192.2 | 1201.1 | 1189.8 | 3.4 | 1216.9 | 1228.9 | 1237.7 | 1246.2 | 1232.4 | 3.6 |
| Investment $82 | 674.4 | 665.6 | 644.9 | 631.0 | 654.0 | 2.8 | 671.8 | 673.4 | 668.1 | 668.4 | 670.4 | 2.5 |
| Non-Residential $82 | 453.2 | 441.0 | 437.7 | 443.2 | 443.8 | −2.3 | 426.0 | 434.2 | 445.3 | 451.9 | 439.3 | −1.0 |
| Producers Durable Equip. $82 | 307.8 | 312.6 | 315.0 | 318.6 | 313.5 | 2.9 | 305.6 | 314.1 | 324.1 | 329.6 | 318.3 | 1.5 |
| Structures $82 | 145.4 | 128.4 | 122.7 | 124.6 | 130.3 | −12.8 | 120.4 | 120.2 | 121.2 | 122.3 | 121.0 | −7.1 |
| Residential $82 | 185.9 | 196.5 | 201.1 | 202.2 | 196.4 | 12.5 | 198.2 | 198.0 | 196.4 | 194.3 | 196.7 | 0.2 |
| Inventory Changes $82 | 35.3 | 28.1 | 6.1 | −14.4 | 13.8 | | 47.6 | 41.2 | 26.4 | 22.1 | 34.3 | |
| Net Exports $82 | −122.9 | −146.8 | −161.6 | −151.8 | −145.8 | | −135.2 | −127.8 | −122.9 | −121.0 | −126.7 | |
| Government Purchases $82 | 737.5 | 751.5 | 757.2 | 771.7 | 754.5 | 3.8 | 759.6 | 762.2 | 769.6 | 777.2 | 767.2 | 1.7 |
| Federal Defense $82 | 240.0 | 250.1 | 259.8 | 252.7 | 250.6 | 5.9 | 257.4 | 262.4 | 256.9 | 256.0 | 258.2 | 3.0 |
| Federal Civilian $82 | 82.0 | 80.4 | 72.8 | 91.9 | 81.8 | −6.5 | 69.9 | 63.9 | 74.1 | 80.7 | 72.2 | −11.8 |
| State & Local $82 | 415.5 | 421.0 | 424.6 | 427.1 | 422.0 | 4.8 | 432.3 | 435.9 | 438.6 | 440.6 | 436.8 | 3.5 |
| Final Sales: $82 | 3663.5 | 3676.6 | 3711.9 | 3745.9 | 3699.5 | 2.8 | 3724.6 | 3755.2 | 3796.9 | 3827.8 | 3776.1 | 2.1 |
| % Change, Annual Rates | 1.2 | 1.4 | 3.9 | 3.7 | 2.8 | | −2.3 | 3.3 | 4.5 | 3.3 | 2.1 | |
| Domestic Demand: $82 | 3821.7 | 3851.5 | 3879.6 | 3883.3 | 3859.0 | 3.9 | 3907.4 | 3924.2 | 3946.3 | 3970.9 | 3937.2 | 2.0 |
| % Change, Annual Rates | 4.5 | 3.2 | 3.0 | 0.4 | 3.9 | | 2.5 | 1.7 | 2.3 | 2.5 | 2.0 | |
| GNP Price Index (1982 = 100) | 112.9 | 113.7 | 114.7 | 114.9 | 114.0 | 2.6 | 116.1 | 117.2 | 118.8 | 120.5 | 118.2 | 3.6 |
| % Change, Annual Rates | 1.8 | 2.9 | 3.6 | 0.7 | 2.6 | | 4.2 | 3.8 | 5.5 | 5.9 | 3.6 | |
| Consumer Price Index (1967 = 100) | 327.7 | 326.6 | 328.6 | 330.7 | 328.4 | 1.9 | 335.0 | 339.0 | 343.6 | 348.4 | 341.5 | 4.0 |
| % Change, Annual Rates | 1.6 | −1.3 | 2.4 | 2.7 | 1.9 | | 5.3 | 4.9 | 5.5 | 5.7 | 4.0 | |
| Total Personal Income | 3463.4 | 3526.6 | 3553.6 | 3593.6 | 3534.3 | 6.2 | 3662.0 | 3716.4 | 3735.5 | 3823.0 | 3734.2 | 5.7 |
| Disposable Personal Income | 2966.0 | 3022.4 | 3038.2 | 3061.6 | 3022.0 | 6.4 | 3125.9 | 3138.5 | 3196.4 | 3269.5 | 3182.6 | 5.3 |
| Savings Rate (%) | 4.7 | 5.5 | 3.6 | 3.6 | 4.3 | | 4.4 | 3.2 | 3.3 | 3.7 | 3.6 | |
| Unemployment Rate (%) | 7.1 | 7.1 | 6.9 | 6.8 | 7.0 | | 6.7 | 6.2 | 6.0 | 5.9 | 6.2 | |
| Indus. Production (1977 = 100) | 125.0 | 124.4 | 125.0 | 126.0 | 125.1 | 1.0 | 127.0 | 127.8 | 130.3 | 131.3 | 129.1 | 3.2 |
| Housing Starts (000) | 1938.0 | 1878.3 | 1758.3 | 1702.3 | 1819.3 | 4.4 | 1794.7 | 1611.7 | 1695.1 | 1669.8 | 1692.8 | −7.0 |
| Domestic Auto Sales (000) | 7837.0 | 8144.7 | 9699.7 | 7876.7 | 8389.5 | 2.3 | 6786.7 | 7007.9 | 7382.1 | 6933.9 | 7027.6 | −16.2 |
| Corporate Pre-Tax Profits | 222.5 | 227.7 | 240.4 | 259.6 | 237.5 | 6.5 | 267.6 | 258.9 | 283.5 | 285.5 | 273.9 | 15.3 |
| −Taxes | 95.6 | 98.9 | 104.5 | 115.1 | 103.5 | | 128.8 | 121.4 | 133.6 | 137.4 | 130.3 | |
| Net Profits | 126.9 | 128.8 | 135.9 | 144.5 | 134.0 | 2.0 | 138.8 | 137.5 | 149.9 | 148.1 | 143.6 | 7.1 |
| −Dividend Payments | 85.2 | 87.5 | 88.8 | 89.7 | 87.8 | 7.6 | 91.4 | 93.9 | 96.1 | 98.4 | 95.0 | 8.2 |
| Undistributed Profits | 41.7 | 41.3 | 47.1 | 54.8 | 46.2 | −7.1 | 47.4 | 43.6 | 53.8 | 49.6 | 48.6 | 5.2 |
| +Depreciation | 332.6 | 333.7 | 337.1 | 344.3 | 336.9 | | 362.0 | 364.0 | 367.1 | 371.3 | 366.1 | |
| −Inventory Profits | −16.5 | −10.6 | −6.1 | 7.2 | −6.5 | | 6.9 | 9.4 | 11.6 | 12.7 | 10.2 | |
| Net Cash Flow | 390.8 | 385.6 | 390.3 | 391.9 | 389.6 | 3.8 | 402.5 | 398.1 | 409.4 | 408.1 | 404.5 | 3.8 |



As you know, the dollar has dropped significantly against a number of key currencies since reaching a peak back in February 1985. In less than 2½ years, the dollar has fallen by about 42 percent against the Japanese yen and German mark, around 40 percent against the French and Belgian francs and the Dutch guilder, and more than 30 percent against the British pound and the Italian lira. Although these countries represent less than 48 percent of our bilateral trade, the rise in their currencies against the dollar was substantial enough to turn the tide in our trade deficit.

Demand for U.S.-made goods is once more climbing. In the last three calendar quarters, the shrinkage in our foreign trade deficit has added about one percentage point to economic growth, whereas in the previous three quarters the widening of the trade deficit subtracted about one percentage point.

### . . . But No Guarantees For 1988

While the trade deficit is expected to shrink further, there are some questions regarding how much longer it can help keep the economy afloat. For one thing, the dollar has strengthened somewhat against the major currencies since bottoming out in the spring. For another, as observed above, the countries against whose currencies the dollar has fallen markedly represent less than half of our two-way trade. Against the currencies of many other countries–including Canada, our largest trading partner–the dollar has fallen very little since early 1985, and in some cases has actually increased.

The Manufacturers Hanover trade-weighted dollar (Economic Report–September 1986) takes this broader array of countries into account. When compared with the currencies of the countries with which we do 80 percent of our trade, the dollar has fallen by less than 10 percent before adjusting for inflation, and less than three percent in real terms. By contrast, the Federal Reserve's measure shows a drop of about 40 percent. It would appear that, unless the dollar falls further–especially against the currencies where it hasn't fallen all that much–the U.S. trade deficit will not decline as fast as needed to keep us out of recession.

Keep in mind that domestic demand grew only two-fifths as much in the last three quarters as it did in the previous three; it is likely to grow even more slowly in the months ahead because of the negative effects arising from more inflation (less buying power), higher interest rates (less borrowing power) and a jittery stock market (less confidence). If the trade deficit fails to decline enough to offset this weakness in demand, there will be nothing left to keep us out of recession.

While 1988 is a presidential election year, it doesn't automatically guarantee that the economy will continue to grow. It may be unusual for us to encounter a recession during a year divisible by four–but it is not unprecedented. The U.S. economy was in recession from January until July 1980, and before that, from April 1960 until February 1961. In both of these presidential election years, the party that occupied the White House was subsequently forced by the voters to vacate.

The selection of Alan Greenspan to replace Paul Volcker as Chairman of the Federal Reserve Board has been interpreted by some as a reason to expect continued economic growth in 1988. In fact, it may do just the opposite. To establish the credibility his predecessor already has, Mr. Greenspan may have to push up interest rates faster than Mr. Volcker would have to keep the dollar stable and contain inflation psychology. ■

MANUFACTURERS HANOVER

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American-Italian Pasta Company
a joint venture between
Richard Thompson and FinPetrini S.p.A.
$22,233,000
13-month construction loan converting to a 5-year term loan
for a
Durum Wheat Mill and Pasta Production Facility
The CIT Group/Equipment Financing's Project Finance Division structured and provided the financing for the above transaction.
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$10,000,000
Debt Funding on Lease Transactions
for
Data Processing Equipment
The CIT Group/Equipment Financing's Chicago office provided the financing for the above transaction.
Affiliated Food Stores, Inc.
$8,613,000
Leveraged Lease
for
Tractors and Trailers
The CIT Group/Equipment Financing's Boston office provided the debt financing for the above transaction with American Finance Group, Inc. as lessor.
Appalachian Regional Healthcare, Inc.
$4,747,000
Loan and Security Agreement
for
Medical Equipment
The CIT Group/Equipment Financing's Cleveland office provided the debt financing for the above leveraged lease with Financial Investments Associates, Inc. as lessor.
Carlisle Construction Company, Inc.
$4,300,000
Line of Credit
for
Cranes and Excavating Equipment
The CIT Group/Equipment Financing's Columbus office structured and provided the financing for the above transaction.
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$2,600,000
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